

UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF NEW YORK

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ALASKA LABORERS EMPLOYERS :  
RETIREMENT FUND, Individually and On :  
Behalf of All Others Similarly Situated, :

Plaintiff, :

No. 07 Civ. 7402 (GBD)

-against- :

SCHOLASTIC CORPORATION, RICHARD :  
ROBINSON and MARY WINSTON, :

Defendants. :  
-----X

**REPLY AFFIDAVIT OF DAVID ELBAUM**

David Elbaum, being duly sworn, deposes and says:

1. I am senior counsel with the law firm of Simpson Thacher & Bartlett LLP, attorneys for Defendants Scholastic Corporation, Richard Robinson and Mary Winston. I respectfully submit this affidavit in support of Defendant's motion to dismiss the consolidated amended class action complaint. I am fully familiar with the facts and circumstances stated herein, based on personal knowledge, the attached documents, and review of the files maintained by my firm.

2. Attached hereto as Exhibit 1 are true and correct copies of excerpts from the Form 10-K filed by Scholastic with the SEC on August 8, 2005.

3. Attached hereto as Exhibit 2 is a true and correct copy of Statement of Financial Accounting Standards No. 48, entitled "Revenue Recognition When Right of Return Exists."



David Elbaum

Sworn to before me this 28 day of  
May, 2008.



Notary Public

BABS S. DOBBS  
Notary Public, State of New York  
~~0100~~ No. 24-4946650  
Qualified in Kings County  
Commission Expires February 6, ~~2011~~

# **EXHIBIT 1**

United States  
Securities and Exchange Commission

Washington, D.C. 20549

Form 10-K

Annual Report pursuant to section 13 or 15(d) of  
the Securities Exchange Act of 1934

For the fiscal year ended May 31, 2005 | Commission File No. 000-19860

**Scholastic Corporation**

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

13-3385513  
(IRS Employer Identification No.)

557 Broadway, New York, New York  
(Address of principal executive offices)

10012  
(Zip Code)

Registrant's telephone number, including area code: (212) 343-6100

Securities Registered Pursuant to Section 12(b) of the Act:

NONE

Securities Registered Pursuant to Section 12(g) of the Act:

Title of class	Name of Each Exchange on Which Registered
Common Stock, \$0.01 par value	The NASDAQ Stock Market

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ☒ No ☐

The aggregate market value of the Common Stock, par value \$0.01, held by non-affiliates as November 30, 2004, was approximately \$1,001,610,000. As of such date, non-affiliates held no shares of the Class A Stock, \$0.01 par value. There is no active market for the Class A Stock.

The number of shares outstanding of each class of the Registrant's voting stock as of July 22, 2005 was as follows: 39,194,645 shares of Common Stock and 1,656,200 shares of Class A Stock.

**Documents Incorporated By Reference**

Part III incorporates certain information by reference from the Registrant's definitive proxy statement for the Annual Meeting of Stockholders to be held September 21, 2005.

## Part I

## Item 1 | Business

## Overview

Scholastic Corporation (the "Corporation" and together with its subsidiaries, "Scholastic" or the "Company") is a global children's publishing and media company. The Company is the world's largest publisher and distributor of children's books. Scholastic creates quality educational and entertaining materials and products for use in school and at home, including children's books, textbooks, magazines, technology-based products, teacher materials, television programming, film, videos and toys. The Company distributes its products and services through a variety of channels, including school-based book clubs, school-based book fairs, school-based and direct-to-home continuity programs, retail stores, schools, libraries, the internet and television networks. The Company's website, [scholastic.com](http://scholastic.com), is a leading site for teachers, classrooms and parents, and an award-winning destination for children. The Company is the leading operator in the United States of direct-to-home book clubs primarily serving children age five and under, and the leading print and on-line publisher of children's reference and non-fiction products sold primarily to United States school libraries. Internationally, Scholastic has long-established operations in Canada, the United Kingdom, Australia, New Zealand and, through its wholly owned subsidiary, Grolier Incorporated ("Grolier"), Southeast Asia and also has newer operations in Argentina, China, India, Ireland and Mexico.

During its 85 years of operation, Scholastic has emphasized quality products and a dedication to learning. Scholastic Corporation was incorporated under the laws of Delaware in 1986 and, through predecessor entities, has been in business since 1920. Grolier, through its predecessor entities, has been in business since 1895.

## Operating Segments

The Company categorizes its businesses into four operating segments: *Children's Book Publishing and Distribution*; *Educational Publishing*; *Media, Licensing and Advertising* (which collectively represent the Company's domestic operations); and *International*. This classification reflects the nature of products and services consistent with the method by which the Company's chief operating decision-maker assesses operating performance and allocates resources. Revenues and operating margin related to a segment's products sold or services rendered through another segment's distribution channel are reallocated to the segment originating the products or services. During the three-year period ended May 31, 2005, Scholastic's revenues have grown at an average annual compounded rate of 2.8%. The following table sets forth revenues by operating segment for the three fiscal years ended May 31:

	(Amounts in millions)		
	2005	2004	2003
Children's Book Publishing and Distribution	\$ 1,152.5	\$ 1,358.6	\$ 1,189.9
Educational Publishing	404.6	369.1	325.9
Media, Licensing and Advertising	133.1	136.4	123.5
International	389.7	369.7	319.0
<b>Total</b>	<b>\$ 2,079.9</b>	<b>\$ 2,233.8</b>	<b>\$ 1,958.3</b>

Additional financial information covering the Company's operating segments is included in Note 2 of Notes to Consolidated Financial Statements in Item 8, "Consolidated Financial Statements and Supplementary Data," which is incorporated herein by reference.

#### CHILDREN'S BOOK PUBLISHING AND DISTRIBUTION

(55.4% of fiscal 2005 revenues)

## General

The Company's *Children's Book Publishing and Distribution* segment includes the publication and distribution of children's books in the United States



*Clifford The Big Red Dog*®, *The Magic School Bus*®, *The Real Mother Goose*™, *No David!* and *Dear Mrs. LaRue*. The products are available through independent toy/gift stores, specialty chains, department stores, mail order catalogs and bookstores, as well as through Scholastic's school-based book clubs, school-based book fairs and continuity programs.

#### Consumer Software

Scholastic distributes original and licensed consumer software, handheld and console products and accessories and DVD's for grades K to 8 through its school-based software clubs, school-based book clubs, school-based book fairs and continuity programs, as well as the school-based library/teacher market and the trade market. The Company acquires software and multi-media products for distribution in all of these channels through a combination of licensing, purchases of product from software publishers and internal development. Scholastic's school-based software clubs are marketed in the same manner as its school-based book clubs. The Company's CD-ROM titles include the award-winning series *I Spy*™, *Clifford*® and *Math Missions*™. The Company and Fisher-Price are developing interactive educational products to be launched in the fall of 2005, including the *Read with Me DVD!* learning system.

#### Advertising

Certain of the Company's magazine properties generate advertising revenues as their primary source of revenue, including *Instructor*®, *Scholastic Administrator*™, *Instructor New Teacher*, *Scholastic Early Childhood Today*™ and *Coach and Athletic Director*™, which are directed to teachers and education professionals and are distributed during the academic year. Total circulation for these magazines was approximately 500,000 in fiscal 2005. Subscriptions for these magazines are solicited primarily by direct mail. *Scholastic Parent and Child*® magazine, which is directed at parents and distributed through schools and childcare programs, had circulation of approximately 1.2 million in fiscal 2005. These magazines carry paid advertising, advertising for Scholastic's other products and paid advertising for clients that sponsor customized programs.

#### Other

Also included in this segment are: Scholastic In-School Marketing, which develops sponsored educational materials and supplementary classroom programs in partnership with corporations, government agencies and nonprofit organizations; Back to Basics Toys®, acquired in fiscal 2004, a direct-to-home catalog business specializing in children's toys; and Quality Education Data, which develops and markets databases and provides research and analysis focused on teachers, schools and education.

#### INTERNATIONAL (18.7% of fiscal 2005 revenues)

##### General

The *International* segment includes the publication and distribution of products and services outside the United States by the Company's international operations, and its export and foreign rights businesses.

Scholastic has long-established operations in Canada, the United Kingdom, Australia, New Zealand and Southeast Asia and also has newer operations in Argentina, China, India, Ireland and Mexico. Scholastic's operations in Canada, the United Kingdom and Australia generally mirror its United States business model. Each of these international operations has original trade and educational publishing programs, distributes children's books, software and other materials through school-based book clubs, school-based book fairs, trade channels and direct-to-home continuity programs, distributes magazines and offers on-line services. Each of these operations has established its own export and foreign rights licensing programs and is a licensee of book tie-ins for major media properties. Original books published by each of these operations have received awards of excellence in children's literature. In Southeast Asia, the Company primarily publishes and distributes reference products and provides services, generally under the Grolier name.



**Canada**

Scholastic Canada, founded in 1957, is a leading publisher and distributor of English and French language children's books, is the largest school-based book club and school-based book fair operator in Canada and is one of the leading suppliers of original or licensed children's books to the Canadian trade market. Since 1965, Scholastic Canada has produced quality Canadian-authored books and educational materials. Grolier Canada is a leading operator of direct-to-home continuity programs in Canada.

**United Kingdom**

Scholastic UK, founded in 1964, is the largest school-based book club and school-based book fair operator and a leading children's publisher in the United Kingdom. Scholastic UK also publishes magazines for teachers and supplemental educational materials, including professional books. Grolier UK is a leading operator of direct-to-home continuity programs in the United Kingdom.

In fiscal 2003, the Company entered into a joint venture with The Book People Ltd. (together with its affiliates, "The Book People"), a direct marketer of books in the United Kingdom, to distribute books to the home under the Red House® name and through schools under the School Link™ name.

**Australia**

Scholastic Australia, founded in 1968, is the leading publisher and distributor of children's educational materials in Australia and has the largest school-based book club and book fair operation in the country, reaching approximately 90% of the country's primary schools.

**New Zealand**

Scholastic New Zealand, founded in 1964, is the largest children's book publisher and the leading book distributor to schools in New Zealand. Through its school-based book clubs and book fairs, Scholastic New Zealand reaches approximately 90% of the country's primary schools.

**Asia**

The Company's Asia operations primarily sell English language reference materials and local language product through a network of over 1,500 independent door-to-door sales representatives in India, Indonesia, Malaysia, the Philippines, Singapore, Taiwan and Thailand. In India, the Company also operates school-based book clubs and book fairs and publishes original titles in the English and Hindi languages. In the Philippines, the Company also operates school-based book fairs, and in Malaysia, the Company operates school-based book clubs and continuity programs.

**Latin America**

In Latin America, the Company has operations in Mexico, Argentina and Puerto Rico. These businesses principally distribute books and educational material published by Scholastic, as well as merchandise from other publishers, through school-based book clubs and book fairs. In Puerto Rico, Scholastic distributes Spanish language reference materials through a network of independent door-to-door sales representatives.

**Foreign Rights and Export**

The Company licenses the foreign-language rights to selected Scholastic titles to other publishing companies around the world in over 40 languages. The Company's export business sells Scholastic books and products in regions of the world not otherwise serviced by Scholastic subsidiaries.



## Results of Operations

(\$ amounts in millions, except per share data)

For fiscal years ended May 31,

	2005		2004		2003	
	Restated <sup>(1)</sup>		Restated <sup>(1)</sup>		Restated <sup>(1)</sup>	
	\$	% <sup>(2)</sup>	\$	% <sup>(2)</sup>	\$	% <sup>(2)</sup>
<b>Revenues:</b>						
Children's Book Publishing and Distribution	1,152.5	55.4	1,358.6	60.8	1,189.9	60.8
Educational Publishing	404.6	19.5	369.1	16.5	325.9	16.6
Media, Licensing and Advertising	133.1	6.4	136.4	6.1	123.5	6.3
International	389.7	18.7	369.7	16.6	319.0	16.3
<b>Total revenues</b>	<b>2,079.9</b>	<b>100.0</b>	<b>2,233.8</b>	<b>100.0</b>	<b>1,958.3</b>	<b>100.0</b>
Cost of goods sold (exclusive of depreciation)	970.5	46.7	1,080.0	48.3	882.1	45.0
Cost of goods sold – Continuity charges <sup>(3)</sup>	—	—	6.8	0.3	—	—
Selling, general and administrative expenses	845.4	40.6	854.9	38.3	813.1	41.5
Selling, general and administrative expenses – Continuity charges <sup>(3)</sup>	3.8	0.2	15.2	0.7	—	—
Bad debt expense	62.2	3.0	88.3	4.0	72.3	3.7
Bad debt expense – Continuity charges <sup>(3)</sup>	—	—	2.0	0.1	—	—
Depreciation and amortization	63.1	3.0	62.1	2.8	52.1	2.7
Special severance charges <sup>(4)</sup>	—	—	3.3	0.1	10.9	0.6
Litigation and other charges <sup>(5)</sup>	—	—	—	—	1.9	0.1
<b>Operating income</b>	<b>134.9</b>	<b>6.5</b>	<b>121.2</b>	<b>5.4</b>	<b>125.9</b>	<b>6.4</b>
Other income <sup>(6)</sup>	—	—	8.0	0.4	2.9	0.2
Interest income	1.0	—	0.4	—	0.3	—
Interest expense	36.2	1.7	40.0	1.8	38.6	2.0
Earnings before income taxes	99.7	4.8	89.6	4.0	90.5	4.6
Net income	64.3	3.1	57.8	2.6	58.8	3.0
<b>Earnings per share:</b>						
Basic	1.61		1.47		1.50	
Diluted	1.58		1.44		1.46	

Certain prior year amounts have been reclassified to conform with the present year presentation.

- (1) The Company has restated its previously issued annual and interim consolidated financial statements to appropriately classify certain leases as capital leases and reflect future payment escalation clauses in determining rent expense for certain operating leases. See "Critical Accounting Policies and Estimates" and Note 1 of Notes to Consolidated Financial Statements in Item 8, "Consolidated Financial Statements and Supplementary Data," for a comprehensive description of the adjustments recorded in connection with the restatement.
- (2) Represents percentage of total revenues.
- (3) In fiscal 2004, the Company recorded pre-tax charges of \$25.4, or \$0.41 per diluted share, in connection with a review of its continuity business. These charges have been recorded primarily as components of: Cost of goods sold; Selling, general and administrative expenses; and Bad debt expense. In fiscal 2005, the Company recorded additional pre-tax charges of \$3.8, or \$0.06 per diluted share, primarily related to severance costs due to the review of its continuity business, which have been recorded as a component of Selling, general and administrative expenses.
- (4) In fiscal 2004 and 2003, the Company recorded pre-tax Special severance charges of \$3.3, or \$0.05 per diluted share, and \$10.9, or \$0.18 per diluted share, respectively, relating to a reduction in its work force announced in May 2003 but implemented in those periods.
- (5) The fiscal 2003 pre-tax charge of \$1.9, or \$0.03 per diluted share, relates to the settlement of a securities lawsuit initiated in 1997.
- (6) In fiscal 2004, the Company recorded a pre-tax net gain of \$8.0, or \$0.13 per diluted share, in connection with the early termination of a sublease by one of its tenants. In fiscal 2003, the Company sold a portion of an equity investment, resulting in a pre-tax gain of \$2.9, or \$0.05 per diluted share.





approximately \$25 million, from \$125.9 million, or 6.4% of revenues, in fiscal 2003.

In fiscal 2004, the Company recorded \$8.0 million in Other income, representing the net gain on the early termination of a sublease by one of its tenants. Other income was \$2.9 million in fiscal 2003, representing a gain from the sale of a portion of an interest in a French publishing company.

Interest expense for fiscal 2005 decreased \$3.8 million to \$36.2 million, as compared to \$40.0 million in fiscal 2004. This decrease was primarily due to lower debt levels. Interest expense for fiscal 2004 increased \$1.4 million, as compared to \$38.6 million in fiscal 2003.

The Company's effective tax rates were 35.5%, 35.5% and 35.0% of earnings before taxes for fiscal 2005, 2004 and 2003, respectively.

Net income increased 11.2% to \$64.3 million, or 3.1% of revenues, in fiscal 2005, from \$57.8 million, or 2.6% of revenues, in fiscal 2004. Net income decreased modestly in fiscal 2004 from \$58.8 million, or 3.0% of revenues, in fiscal 2003. The basic and diluted earnings per share of Class A Stock and Common Stock were \$1.61 and \$1.58, respectively, in fiscal 2005, \$1.47 and \$1.44, respectively, in fiscal 2004, and \$1.50 and \$1.46, respectively, in fiscal 2003.

#### Results of Operations – Segments

In fiscal 2005, the Company reviewed the estimated Cost of goods sold related to products originated by the *Media, Licensing and Advertising* segment that are sold through channels included in the *Children's Book Publishing and Distribution* segment. The Company determined that actual costs were lower and gross margins higher on these products than was previously estimated. As a result, the current and prior year inter-segment allocations were adjusted (the "Segment Reallocation"), resulting in higher gross margin and profits in the *Media, Licensing and Advertising* segment with an offsetting decrease in gross margin and profits in the *Children's Book Publishing and Distribution* segment.

#### CHILDREN'S BOOK PUBLISHING AND DISTRIBUTION

The Company's *Children's Book Publishing and Distribution* segment includes the publication and distribution of children's books in the United States through school-based book clubs and book fairs, school-based and direct-to-home continuity programs and the trade channel.

(\$ amounts in millions)

	2005	2004	2003
Revenue	\$ 1,152.5	Restated \$ 1,358.6	Restated \$ 1,189.9
Operating profit <sup>(1)</sup>	93.5(2)	104.6(2)	123.7
Operating margin <sup>(1)</sup>	8.1%	7.7%	10.4%

(1) Reflects the Segment Reallocation.

(2) Operating profit includes the portion of the Continuity charges related to this segment of approximately \$4 in fiscal 2005 and approximately \$22 in fiscal 2004.

*Children's Book Publishing and Distribution* revenues accounted for 55.4% of the Company's revenues in fiscal 2005 and 60.8% in both fiscal 2004 and fiscal 2003. In fiscal 2005, segment revenues decreased 15.2%, or \$206.1 million, to \$1,152.5 million from \$1,358.6 million in fiscal 2004. This decrease relates primarily to a decline in the Company's trade business of \$142.2 million. Continuity program revenues decreased \$73.8 million, as compared to the prior fiscal year, consistent with the Company's previously announced plan to focus on its more productive continuity customers. These revenue decreases were partially offset by an increase of \$17.0 million in revenues from the school-based book fairs business, as compared to the prior fiscal year.

In fiscal 2004, segment revenues increased 14.2%, or \$168.7 million, from \$1,189.9 million in fiscal 2003. This increase was primarily due to higher trade revenues of approximately \$110 million driven by the release of the fifth *Harry Potter* book, *Harry Potter and the Order of the Phoenix*, as well as higher revenues from school-based book club and school-based book fairs, which increased \$53.5 million and \$18.0 million, respectively. These increases were partially offset by a decline in



continuity program revenues of \$15.5 million as compared to the prior fiscal year.

School-based book club revenues accounted for 34.4% of *Children's Book Publishing and Distribution* revenues in fiscal 2005, compared to 29.7% in fiscal 2004 and 29.5% in fiscal 2003. In fiscal 2005, school-based book club revenues decreased by 1.8%, or \$7.1 million, to \$396.9 million, as compared to fiscal 2004, primarily due to lower revenue per order. In fiscal 2004, school-based book club revenues improved by 15.3%, or \$53.5 million, to \$404.0 million, as compared to fiscal 2003, primarily due to an increase in the number of orders aided by the July 2003 acquisition of selected assets of Troll Holdings, Inc., formerly a national school-based book club operator and publisher ("Troll").

Revenues from school-based book fairs accounted for 31.5% of segment revenues in fiscal 2005, compared to 25.4% in fiscal 2004 and 27.5% in fiscal 2003. In fiscal 2005, school-based book fair revenues increased by 4.9%, or \$17.0 million, to \$362.6 million, over fiscal 2004, which had increased 5.5%, or \$18.0 million, to \$345.6 million versus fiscal 2003. These increases were primarily due to growth in revenue per fair.

In fiscal 2005, continuity revenues accounted for 18.4% of segment revenues, as compared to 21.0% in fiscal 2004 and 25.3% in fiscal 2003. Revenues from the continuity business in fiscal 2005 decreased 25.8%, or \$73.8 million, to \$212.1 million, as compared to fiscal 2004, consistent with the Company's previously announced plan to focus on its more productive customers. Revenues from the continuity business in fiscal 2004 decreased 5.1%, or \$15.5 million, to \$285.9 million, as compared to fiscal 2003, principally as a result of lower net revenues generated through telemarketing, which was adversely affected by the implementation, effective October 1, 2003, of the National Do Not Call Registry legislation.

The trade distribution channel accounted for 15.7% of segment revenues in fiscal 2005, as compared to 23.9% in fiscal 2004 and 17.7% in fiscal 2003. Trade revenues decreased in fiscal 2005 by \$142.2 million, or 44.0%, to \$180.9 million, compared to \$323.1 million in fiscal 2004, principally due to a decline in *Harry Potter* revenues of approximately \$155 million, partially offset by increased non-*Harry Potter* revenues. In fiscal 2004, trade revenues increased 53.6%, or \$112.7 million, from \$210.4 million in fiscal 2003, substantially due to the fiscal 2004 release of *Harry Potter and the Order of the Phoenix*. Trade revenues for *Harry Potter* were approximately \$20 million, \$175 million and \$50 million in fiscal 2005, 2004 and 2003, respectively.

Segment operating profit in fiscal 2005 declined \$11.1 million, or 10.6%, to \$93.5 million, or 8.1% of revenues, compared to \$104.6 million, or 7.7% of revenues, in fiscal 2004. This decline was principally due to lower operating results for the Company's trade business, which decreased by approximately \$27 million, primarily due to lower *Harry Potter* revenues, partially offset by an increase in operating profit from continuity programs of approximately \$22 million. In fiscal 2004, the Company experienced greater than anticipated challenges in its continuity business, including the effects of the National Do Not Call Registry legislation. These challenges resulted in lower net revenue generated through telemarketing, increased promotion costs and higher bad debt provisions. As a result, the Company reviewed and made changes in its continuity business in fiscal 2004, and recorded Continuity charges in fiscal 2004 and fiscal 2005 of approximately \$25 million and \$4 million, respectively, of which approximately \$22 million and \$4 million, respectively, applied to this segment.

In fiscal 2004, segment operating profit declined \$19.1 million, or 15.4%, compared to \$123.7 million, or 10.4% of revenues, in fiscal 2003. This decline was primarily due to lower operating results for continuity programs, which decreased by approximately \$55 million in fiscal 2004, partially offset by improvements in the Company's trade business of approximately \$20 million, resulting primarily from higher *Harry*



Potter revenues, and in the school-based book club business of approximately \$15 million.

The following highlights the results of the direct-to-home portion of the Company's continuity programs, which consists primarily of the business formerly operated by Grolier and included in the *Children's Book Publishing and Distribution* segment.

Direct-to-home continuity (\$ amounts in millions)

	2005	2004	2003
Revenue	\$ 147.5	Restated 203.8	Restated 212.3
Operating (loss) profit	(2.8) <sup>(1)</sup>	(10.4) <sup>(1)</sup>	30.9
Operating margin	*	*	14.6%

\* not meaningful

(1) Operating loss includes the direct-to-home portion of the Continuity charges related to this segment of approximately \$4 in fiscal 2005 and approximately \$15 in fiscal 2004. In fiscal 2005, revenues from the direct-to-home portion of the Company's continuity business decreased to \$147.5 million, from \$203.8 million in fiscal 2004, compared to \$212.3 million in fiscal 2003.

The direct-to-home continuity business operating loss was \$2.8 million in fiscal 2005 compared to a \$10.4 million operating loss in fiscal 2004, primarily due to the approximately \$15 million effect of the prior year Continuity charge attributable to the direct-to-home portion of the continuity business. In fiscal 2003, operating profit from the direct-to-home continuity business was \$30.9 million.

Excluding the direct-to-home continuity business, segment revenues in fiscal 2005 were \$1,005.0 million, as compared to \$1,154.8 million in fiscal 2004 and \$977.6 million in fiscal 2003, and segment operating profit in fiscal 2005 was \$96.3 million, compared to \$115.0 million in fiscal 2004 and \$92.8 million in fiscal 2003.

#### EDUCATIONAL PUBLISHING

The Company's *Educational Publishing* segment includes the publication and distribution to schools and libraries of educational technology products, curriculum materials, children's books, classroom magazines and print and on-line reference and non-fiction products for grades pre-K to 12 in the United States.

(\$ amounts in millions)

	2005	2004	2003
Revenue	\$ 404.6	Restated 369.1	Restated 325.9
Operating profit	78.5	56.1	43.8
Operating margin	19.4%	15.2%	13.4%

Segment revenues accounted for 19.5% of the Company's revenues in fiscal 2005, compared to 16.5% in fiscal 2004 and 16.6% in fiscal 2003. In fiscal 2005, *Educational Publishing* revenues increased to \$404.6 million from \$369.1 million in fiscal 2004. This \$35.5 million increase was primarily due to higher revenues from sales of educational technology products, including the Company's *READ 180* reading intervention program. In fiscal 2004, the \$43.2 million increase in *Educational Publishing* revenues as compared to fiscal 2003 was primarily due to higher sales of children's books to public schools systems as classroom libraries and other collections, which increased \$28.3 million, and educational technology products, which increased \$17.4 million.

Segment operating profit in fiscal 2005 increased by \$22.4 million, or 39.9%, to \$78.5 million, as compared to the prior fiscal year, primarily due to revenue growth from sales of educational technology products, which have higher gross margins. In fiscal 2004, segment operating profit increased \$12.3 million, or 28.1%, from \$43.8 million in fiscal 2003, primarily due to the increase in revenues, as well as improved gross margins resulting from a favorable sales mix.

#### MEDIA, LICENSING AND ADVERTISING

The Company's *Media, Licensing and Advertising* segment includes the production and/or distribution of software in the United States; the production and/or distribution, primarily by and through SEI, of programming and consumer products (including children's television programming, videos, software, feature films, promotional activities and non-book merchandise); and advertising revenue, including sponsorship programs.



(\$ amounts in millions)

	2005	2004	2003
Revenue	\$ 133.1	Restated 136.4	Restated 123.5
Operating profit <sup>(1)</sup>	11.0	10.9	12.2
Operating margin <sup>(1)</sup>	8.3%	8.0%	9.9%

(1) Reflects the Segment Reallocation.

Media, Licensing and Advertising revenues accounted for 6.4% of the Company's revenues in fiscal 2005, 6.1% in fiscal 2004 and 6.3% in fiscal 2003. In fiscal 2005, segment revenues decreased by \$3.3 million, or 2.4%, to \$133.1 million from \$136.4 million in fiscal 2004. This decrease was due principally to a decline of \$6.8 million in programming revenue, primarily as a result of the fiscal 2004 release of the feature film *Clifford's Really Big Movie*, partially offset by increased revenues of \$2.9 million from Back to Basic Toys, the Company's direct-to-home toy catalog. In fiscal 2004, segment revenues increased by \$12.9 million, or 10.4%, from \$123.5 million in fiscal 2003, primarily due to \$17.5 million of incremental revenues generated from Back to Basics Toys, which the Company acquired in August 2003. Additionally, programming revenues increased by \$5.9 million, primarily due to the effect of *Clifford's Really Big Movie*. These revenue increases were partially offset by \$9.6 million in decreased revenues from software and multimedia products.

Media, Licensing and Advertising operating profit remained relatively flat at \$11.0 million, or 8.3% of revenues, in fiscal 2005, compared to \$10.9 million, or 8.0% of revenues, in fiscal 2004. In fiscal 2004, profit decreased \$1.3 million from \$12.2 million, or 9.9% of revenues, in fiscal 2003.

## INTERNATIONAL

The International segment includes the publication and distribution of products and services outside the United States by the Company's international operations, and its export and foreign rights businesses.

(\$ amounts in millions)

	2005	2004	2003
Revenue	\$ 389.7	Restated 369.7	Restated 319.0
Operating profit	30.3	23.5(1)	19.3
Operating margin	7.8%	6.4%	6.1%

(1) Fiscal 2004 operating profit includes the portion of the Continuity charges related to this segment of approximately \$3.

International revenues accounted for 18.7% of the Company's revenues in fiscal 2005, 16.6% in fiscal 2004 and 16.3% in fiscal 2003. Segment revenues increased \$20.0 million, or 5.4%, to \$389.7 million in fiscal 2005 from \$369.7 million in fiscal 2004, primarily due to the favorable impact of foreign currency exchange rates. In fiscal 2004, International revenues increased \$50.7 million, or 15.9%, from \$319.0 million in fiscal 2003, primarily due to the favorable impact of foreign currency exchange rates of \$36.5 million and increased revenues from the Company's export business of \$12.3 million.

International operating profit increased \$6.8 million to \$30.3 million, or 7.8% of revenues, in fiscal 2005 from \$23.5 million, or 6.4% of revenues, in fiscal 2004. This increase was primarily due to higher operating profit in Australia. In fiscal 2004, operating profit increased \$4.2 million, or 21.8%, from \$19.3 million, or 6.1% of revenues, in fiscal 2003, primarily due to an increase in operating profit from the export business.

## Liquidity and Capital Resources

Cash and cash equivalents were \$110.6 million at May 31, 2005, compared to \$17.8 million at May 31, 2004 and \$58.6 million at May 31, 2003.

Cash flow provided by operations increased \$25.3 million to \$246.6 million in fiscal 2005 compared to \$221.3 million in fiscal 2004, on improved net income of \$6.5 million, primarily as a result of changes in working capital. Inventory decreased by \$3.2 million in fiscal 2005 compared to an increase of \$14.7 in fiscal 2004, primarily due to growth in inventory levels in school-based book clubs and book fairs in fiscal 2004. The deferred income tax provision increased \$17.8 million to \$20.4 million in fiscal 2005 compared to \$2.6 million in fiscal 2004.



# **EXHIBIT 2**

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# Statement of Financial Accounting Standards No. 48

FAS48 Status Page  
FAS48 Summary

Revenue Recognition When Right of Return Exists

June 1981



Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

**Statement of Financial Accounting Standards No. 48**

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**June 1981**

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## FAS 48: Revenue Recognition When Right of Return Exists

### FAS 48 Summary

This Statement specifies how an enterprise should account for sales of its product in which the buyer has a right to return the product. Revenue from those sales transactions shall be recognized at time of sale only if *all* of the conditions specified by the Statement are met. If those conditions are not met, revenue recognition is postponed; if they are met, sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns and expected costs or losses shall be accrued.

### INTRODUCTION

1. As discussed in FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, the FASB is extracting the specialized <sup>1</sup> accounting and reporting principles and practices from AICPA Statements of Position (SOPs) and Guides on accounting and auditing matters and issuing them in FASB Statements after appropriate due process. This Statement extracts the specialized principles and practices from SOP 75-1, *Revenue Recognition When Right of Return Exists*, and establishes accounting and reporting standards for sales of an enterprise's product in which the buyer has a right to return the product.
2. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraphs 10-12 are advisable in the circumstances.

### APPLICABILITY AND SCOPE

3. This Statement specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate customer or by a party who resells the product to others. The product may be returned

for a refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or in exchange for other products. The purchase price or credit may include amounts related to incidental services, such as installation.

4. This Statement does not apply to: (a) accounting for revenue in service industries if part or all of the service revenue may be returned under cancellation privileges granted to the buyer, (b) transactions involving real estate or leases, or (c) sales transactions in which a customer may return defective goods, such as under warranty provisions.

5. This Statement does not modify any of the provisions of FASB Statement No. 49, *Accounting for Product Financing Arrangements*. A product financing arrangement as defined in that Statement should be accounted for as a borrowing rather than as a sale.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Criteria for Recognizing Revenue When Right of Return Exists

6. If an enterprise sells its product but gives the buyer the right to return the product, revenue from the sales transaction shall be recognized at time of sale only if all of the following conditions are met:
  - a. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
  - b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
  - c. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
  - d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.<sup>2</sup>
  - e. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
  - f. The amount of future returns<sup>3</sup> can be reasonably estimated (paragraph 8).

Sales revenue and cost of sales that are not recognized at time of sale because the foregoing conditions are not met shall be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first.

7. If sales revenue is recognized because the conditions of paragraph 6 are met, any costs or losses that may be expected in connection with any returns shall be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*. Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns.

8. The ability to make a reasonable estimate of the amount of future returns depends on many factors and circumstances that will vary from one case to the next. However, the following factors may impair the ability to make a reasonable estimate:

- a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand
- b. Relatively long periods in which a particular product may be returned
- c. Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers
- d. Absence of a large volume of relatively homogeneous transactions

The existence of one or more of the above factors, in light of the significance of other factors, may not be sufficient to prevent making a reasonable estimate; likewise, other factors may preclude a reasonable estimate.

#### **Amendment to Statement 32**

9. The reference to SOP 75-1, *Revenue Recognition When Right of Return Exists*, is deleted from Appendix A of Statement 32. The specialized accounting provisions of that SOP are superseded by this Statement.

#### **Effective Date and Transition**

10. This Statement shall be effective for fiscal years beginning after June 15, 1981, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on sales, income before extraordinary items, net income, and related per-share amounts for each year restated.

11. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying the Statement shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which the Statement is first applied. (Refer to paragraph 20 of APB Opinion No. 20, *Accounting Changes*.) The effect on sales, income before extraordinary items, net income, and related per-share amounts of applying this Statement in a year in which the cumulative effect is included in determining that year's net income shall be disclosed for that year.

12. Retroactive application of the provisions of paragraph 7 may require estimates of returns

and costs or losses from returns that the enterprise has not previously made; information that may have become available after the year being restated may be considered in making those estimates.

**The provisions of this Statement need  
not be applied to immaterial items.**

*This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:*

Donald J. Kirk, *Chairman*  
Frank E. Block  
John W. March  
Robert A. Morgan  
David Mosso  
Robert T. Sprouse  
Ralph E. Walters

## **Appendix A: BACKGROUND INFORMATION**

13. It is the practice in some industries for customers to be given the right to return a product to the seller under certain circumstances. In the case of sales to the ultimate customer, the most usual circumstance is customer dissatisfaction with the product. For sales to customers engaged in the business of reselling the product, the most usual circumstance is that the customer has not been able to resell the product to another party. (Arrangements in which customers buy products for resale with the right to return products often are referred to as *guaranteed sales*.)

14. Sometimes, the returns occur very soon after a sale is made, as in the newspaper and perishable food industries. In other cases, returns occur over a longer period, such as with book publishing and equipment manufacturing. The rate of returns varies considerably from a low rate usually found in the food industry to a high rate often found in the publishing industry.

15. Situations that pose particular problems occur when sales result in significant overstocking by customers acquiring product for resale. In those situations, the recognition of revenue in one period often is followed by substantial returns in a later period.

16. SOP 75-1 was developed to reduce diversity in the accounting for revenue when the right of return exists. The following alternative accounting practices were being used when the SOP was issued: (a) no sale was recognized until the product was unconditionally accepted, (b) a sale was recognized and an allowance for estimated returns was provided, and (c) a sale was recognized without providing an allowance for returns and, instead, sales returns were recognized

when the product was returned. The SOP established criteria that had to be met before sales revenue could be recognized.

17. The Board has not undertaken a comprehensive reconsideration of the accounting issues discussed in SOP 75-1 and has extracted the specialized accounting and reporting principles without significant change. Accordingly, some of the background material and discussion of accounting alternatives have not been carried forward from the SOP. The Board's conceptual framework project on accounting recognition criteria will address revenue recognition issues that may pertain to those addressed in this Statement. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

## **Appendix B: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT**

18. An Exposure Draft of a proposed Statement, *Revenue Recognition When Right of Return Exists*, was issued February 9, 1981. The Board received 36 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in this appendix.

19. Some respondents requested that the Statement not apply to enterprises that account for inventory using the retail method of accounting. They recommended that sales returns of retailers be permitted to be recognized when merchandise actually is returned for refund or credit. They said that method is appropriate because accounting for sales returns at time of sale for each product sold is not cost justified, for three reasons. First, they believe that the results of recognizing sales returns when returns are made gives substantially the same results as applying the provisions of the Statement, that is, the Statement would have an insignificant effect on sales, gross margins, and earnings. Second, they state that enterprises using the retail method have not maintained historic data on sales returns. They believe that determining the percentage of sales of one accounting period returned in a later accounting period would be time-consuming and costly, because of the number of transactions to be reviewed. Third, if they were to follow the provisions of the Statement, providing for estimated returns for each product would be complex and costly. Others disagreed with the suggestion of exempting retailers from the Statement.

20. The Board believes that the fundamental issue is materiality. The Board recognizes that the provisions of this Statement may not materially affect the financial position and results of operations of some enterprises that currently account differently than specified by this Statement. Like other FASB Statements, the provisions of this Statement need not be applied to immaterial items. With respect to those enterprises for which this Statement would have a material effect, the Board recognizes that detailed record keeping for returns for each product line might be



costly in some cases; this Statement permits reasonable aggregations and approximations of product returns.

21. Some respondents suggested that exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) should not be treated as sales returns for purposes of this Statement. They noted that retailers do not account for those exchanges as sales returns. The Board adopted that suggestion in footnote 3.

22. Several respondents, particularly in the publishing industry, expressed concern that the wording of the condition in paragraph 6(b) (paragraph 11(b) of the Exposure Draft) changed its meaning from the similar condition in SOP 75-1. The Board has refined the wording to clarify that the condition is met if the buyer pays the seller at time of sale or if the buyer does not pay at time of sale but is obligated to pay at a specified date or dates. If, however, the buyer does not pay at time of sale and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product, then the condition is not met.

23. The transition provisions in the Exposure Draft proposed that either prospective application with cumulative effect of a change in accounting principles or retroactive restatement be permitted. The Notice for Recipients of the Exposure Draft requested respondents to comment on whether the proposed transition is appropriate or whether the transition provisions should be limited to one of the alternatives. Of those respondents who commented on the transition provisions, a substantial majority recommended that one method be specified, but they disagreed on which method. The Board believes that, for recurring revenue recognition issues, comparability is enhanced if enterprises apply accounting standards retroactively by restating the financial statements of previous periods, and the Board has, therefore, adopted that method in this Statement. This Statement, however, calls for enterprises that are unable to restate previous years' financial statements to include the cumulative effect of those years in the earliest year restated.

24. Several individual respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required a reconsideration of the provisions of SOP 75-1. Those suggestions were not adopted because such a reconsideration is beyond the scope of extracting the specialized accounting and reporting principles and practices from the SOP, none of the changes was broadly supported, and the Board believes the suggestions should not be adopted.

25. Several respondents requested guidance regarding specific implementation questions; for example, treatment of partial or limited refunds and balance sheet presentation of accruals for expected returns. SOP 75-1 did not provide specific guidance about those questions and the Board concluded that it should not address those questions at this time.

### Footnotes

FAS48, Footnote 1--The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

FAS48, Footnote 2--This condition relates primarily to buyers that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents enterprises from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.

FAS48, Footnote 3--Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for purposes of this Statement.